

## **504 OPERATING ASSURANCE RESERVE (OAR) POLICY**

This policy provides guidance regarding the Operating Assurance Reserve (OAR) Policy and procedures for processing OAR disbursement requests. The following topics will be covered:

**Purpose of Operating Assurance Reserve**

**Contributions to OAR**

**OAR Structures**

**Eligible Expenses**

**Requests for OAR Disbursements/Reductions**

**Processing OAR Requests**

**Replacement Reserve Administered by Another Agency**

**Escrow Funding Review Prior to OAR Reduction/Release Eligibility**

**Development Operating Review and OAR Reduction/Release**

**Monitoring the Expiration of the OAR Letters of Credit (LOC)**

**Loan Default or Recapture Obligation Event**

**Discharge of the Mortgage Loan**

### **Purpose of Operating Assurance Reserve**

The OAR helps ensure the stability of a development. During the first years of operation, the reserve can be used for deficits in the operations cash flow. The OAR may also help with RR Needs or other underfunded escrows and obligations to the Authority near the middle of the development's mortgage term.

The OAR was originally called the Operating Assurance Escrow (OAE), but the name changed around February 1999. This policy uses "OAR" but the policy applies to either term.

### **Contributions to the OAR**

When required, the Mortgagor shall establish an OAR with the Authority at or prior to the initial disbursement of the loan proceeds in an amount equal to four months estimated development operating expenses, including debt service payments and deposits to escrows. Six months of estimated development operating expenses, including debt service payments and deposits to escrows are required for developments with a HAP contract (Section 8). Operating expenses will include payments required under the Mortgage Note, operating expenses, and deposits to reserves to cover operating shortfalls at the Development. OAE accounts were generally funded by deferring developer fees until development demonstrated successful operations while OAR accounts since the 1999 conversion have been funded with Mortgage proceeds.

If any funds are disbursed prior to Final Closing to assist with operating shortfalls, the Mortgagor must restore the OAR to its original balance at Final Close. The reserve must be funded with at

least 50% cash after the Cut-off Date. Any portion of the reserve not funded by cash must be funded with an irrevocable letter of credit. The letter of credit's annual fee must be paid by the owner and not from development operations. Interest earned, if any, shall become part of the OAR and shall be treated and disbursed in the same way unless otherwise stated in the Regulatory Agreement.

## OAR Structures

The amount and any special terms governing the OAR are described in the development's Regulatory Agreement and the Commitment Report. **Review these documents carefully to obtain the complete OAR processing parameters for specific events.** During any part of the Authority funded loan term, OAR funds are available for eligible operating expenses as a funding source for deficits. If an Operating Deficit Reserve exists, the OAR becomes a secondary source for funding operating deficits.

After a 12 or 24 month successful operating period, the OAR funds may become eligible for a release/reduction in the balance of funds maintained in the OAR account. Refer to the "Monitoring and Processing OAR Reductions/Releases" section for more details about the successful operations requirements. This may result in either a **reduction** of the Letter of Credit amount required to be held by the Authority or a **release** of the OAR cash to the Operating Reserve Cash (ORC) account. Generally, four different OAR structures have been used in the regulatory agreement language. The OAR structures identify four different eligibility dates and parameters as follows:

### Type 1

OAE accounts prior to February, 1999 are eligible for reduction, if requested by the owner, **beginning** one year from the final closing or cut-off date. Funds are eligible to be reduced/released in thirds over a period of years as designated in the Regulatory Agreement. After each successful 12-month operational period the following reductions may be approved:

- 1<sup>st</sup> successful period allows a 33% reduction/release in the OAR balance.
- 2<sup>nd</sup> successful period allows a 50% reduction/release in the remaining OAR balance.
- 3<sup>rd</sup> successful period allows a 100% reduction/release in the remaining OAR balance.

### Type 2

OAR accounts on newer Developments since February, 1999 are eligible for a reduction/release **beginning** in the 10<sup>th</sup> and 15<sup>th</sup> years after the Cut-off Date. In the 10<sup>th</sup> and 15<sup>th</sup> year, the OAR is used to fund any underfunded escrows including replacement reserve needs identified by an updated CNA. After the escrows have been fully funded and the development achieves 12-months of successful operations, then in the:

- 10<sup>th</sup> year – the OAR balance may be reduced/released by 50%.
- 15<sup>th</sup> year – the OAR balance may be reduced/released by 100%.

If the development has a TCAP loan, released funds are first applied against the TCAP Loan prior to being released to the development's Operational Reserve Cash account.

After the 15<sup>th</sup> year of operation if any funds remain in the OAR, the funds will be transferred to the development's Replacement Reserve account, unless otherwise stated in the Regulatory Agreement, and used in accordance with the Replacement Reserve policy.

### Type 3

OAR accounts on preservation Developments since February, 1999 are eligible for a reduction/release **beginning** in the 6<sup>th</sup> and 12<sup>th</sup> years after the Cut-off Date. In the 6<sup>th</sup> and 12<sup>th</sup> year, the OAR is used to fund any underfunded escrows including replacement reserve needs identified by an updated CNA. After the escrows have been fully funded and the development achieves 12-months of successful operations, then in the:

- 6<sup>th</sup> year – the OAR balance may be reduced/released by 50%.
- 12<sup>th</sup> year – the OAR balance may be reduced/released by 100%.

Additionally, 50% of any released funds may be required to be applied to the Preservation Fund Loan prior to being released to the development's Operating Reserve Cash account. Review the Regulatory Agreement to confirm if the requirement exists.

### Type 4

OAR accounts on Section 8 preservation developments are eligible for a reduction/release **beginning** in the later of the year the HAP contract expires or the 12<sup>th</sup> year after the Cut-off Date.

- The funds can be reduced by 100% at the designated date if 24-months of successful operations have been achieved. Released cash funds are first applied against the TCAP Loan and prior to being released to the development's Operational Reserve Cash account unless otherwise stated in the Regulatory Agreement.

## **Eligible Expenses**

OAR funds may be used to pay for development operating expenses based on the priority set forth in the Management Agreement under Section 5 – Expense Management. Eligible expenses include:

- Payments to maintain the fiscal integrity of the development; and;
- Expenses/payables projected to come due without operating funds being available in the next 30 days.

\* The OAR **cannot** be used to pay Identity of Interest vendors.

## **Requests for OAR Disbursements or Reductions/Releases**

The Owner/Agent may submit written requests for either an OAR disbursement or reduction/release to the assigned Asset Manager.

Disbursements - If an operating deficit requires an OAR funds disbursement, the request must

include the following:

- Owner's approval of the requested disbursement,
- An explanation of the intended use of the funds,
- An explanation for using OAR funds versus another available reserve, if one exists,
- Evidence of the current cash position of the development,
- The amount of the request, which must exceed \$1000.

Reductions/Release - If the Owner requests a reduction/release of OAR Funds, the request for reduction/release must include:

- The amount of the reduction/release being requested,
- A self evaluation of operational success or over the past 12 or 24 months.

- OR -

If an operating deficit occurred and the owner opts to pay for the deficit with cash, the OAR letter of credit balance may be reduced by the amount of the owner's cash advance (or contribution) toward the deficit. For this request include:

- The amount of the reduction to the letter of credit being requested,
- Evidence of the owner's cash advance to the development.

### **Processing OAR Disbursement Requests**

Upon receipt, the assigned Asset Manager will review the development's Regulatory Agreement, the financial eligibility and balance of other escrows, and the OAR policy to evaluate the OAR request. The following items shall be considered:

1. Operating Reserve Cash (ORC) funds – Does the development have any ORC funds available to assist with the deficit? ORC funds should be disbursed before OAR funds are used for any deficit.
2. Operating Deficit Reserve (ODR) – Does the development have any ODR funds available? Have ODR funds been drawn as anticipated per the ODR schedule? ODR funds should be disbursed before any OAR funds are used for an operating deficit. The ODR should be drawn up to the "appropriate level" ending balance amount for the current year before the OAR account is used to pay for an operating deficit.
3. Liquidity of the development
  - a. Liquidity Calculation: *Liquidity* = Total Operating Cash + Receivables – Payables, including Prepaid Rent + ORC balance.
  - b. Developments can maintain up to one month's Gross Rent Potential (GRP) in the development's on-site operating account. Calculation to bring Operating Cash up to One

Month's GRP: *Amount to be processed* = One month's GRP – (Operating Cash + Receivables – Vendor payables)

4. Explanation regarding how the funds will be used. The fund will:
  - a. Pay for operating expenses that provide an **operating benefit** to the development and for which the development does not have the money on-site to support.
  - b. Pay Escrow account shortages, such as tax and insurance deficits or replacement reserve needs.
  - c. Bring the on-site operating cash up to one month's GRP.
5. Determine if the cash portion of the OAR will cover the requested amount. If the draw exceeds the available cash in the OAR account, notify the management agent of the lack of cash funds and discuss the development's options. Refer to the "Monitoring and Processing OAR Letters of Credit" section for more details.

The assigned Asset Manager verifies that the disbursement request meets the eligibility and financial requirements. The processing of the request should be completed within 30 days of receipt by MSHDA.

### **Escrow Funding Review Prior to OAR Reduction/Release Eligibility**

At budgeting time, during the year that the OAR funds becomes eligible for reduction/release (6<sup>th</sup> and 12<sup>th</sup> or 10<sup>th</sup> and 15<sup>th</sup>), the Asset Manager must review the Replacement Reserve (RR) funding levels and any other escrows to determine if the escrows are fully funded. Consideration should be given to the **projected** funding levels for the replacement reserve and other escrow accounts for the life of all obligations due to the Authority. If a Replacement Reserve Need exists, the OAR funds may be used to fully fund the replacement reserve escrow. Any other underfunded escrows may be funded as well. Type 1 OAR structures are not affected by this process, because these reviews should be performed annually.

When beginning the budget review process in the applicable year (10<sup>th</sup> and 15<sup>th</sup> or 6<sup>th</sup> and 12<sup>th</sup>), determine if a RR need exists, by performing the following:

1. *Review the CNA Analysis provided by Amy Rollis for budgeting purposes. The Cumulative RR Needs as of the end of the current year are shown at the bottom of the CNA Analysis.*
2. If no RR Needs exist, review the current CNA plan 1 or 2 for the projected "Additional Contributions per Unit" to determine if the projected contributions are achievable.
3. If a CNA does not exist for the development, determine if the current balance of the replacement reserve equals **\$3,000 per unit or greater** to validate whether the reserve has adequate funding for the future needs of the property.
4. If a RR Need exists, prepare an OAR transfer request to fund the RR needs amount or if no CNA exists, to fund the account at \$3,000 per unit. This may result in the requirement to cash a letter of credit. **Refer to the "Monitoring and Processing OAR Letters of Credit (LOC)" section for more details.**

## Development Operating Review and OAR Reduction/Release

Upon receipt of a reduction request from an owner, the AM will use the Attachment 504A as a guide to review the following items and determine whether the development is operating successfully:

1. Perform a review of the operational success of the development for the past 12 or 24 months, depending on the OAR structure Type. Use the following criteria to evaluate the operational success of a development and make an OAR reduction recommendation. Attachment 504A – Operating Assurance Reserve Development Review provides a structured form for the asset manager’s review:
  - a. Liquidity – Review the entire period to be evaluated for any trends in the development’s operation. If the trends are different from the development’s condition at the time of review, an explanation should be included with the recommendation.
    1. All developments except Section 8 Preservation with expired HAP: For the past 12 months preceding the review, the operating liquidity position (excluding owner contributions) has remained at or above one month’s gross rent potential - **and** - the average occupancy has remained above 95%.
    2. Section 8 Preservation Development – After HAP has expired: For the past 24 months, the operating liquidity position (excluding owner contributions) has remained at or above one month’s gross rent potential - **and** - the average economic vacancy equals 5% or less of the yearly MSHDA-approved budgeted gross rent potential.
  - b. Mortgage Delinquency - No mortgage delinquencies exist and payments have been current during the preceding 12 months through the date of the potential pending release of OAR.
  - c. Escrow Funding - All escrow accounts, for example the tax, insurance, and replacement reserve are fully funded. Consideration should be given to the **projected** funding levels for the replacement reserve for the life of all outstanding loans due to the Authority.
  - d. Operating Deficit Reserve - No Operating Deficit Reserve (ODR) funds have been withdrawn in the preceding 12 months through the potential pending release of the OAR funds. If ODR funds have been withdrawn, they must be reimbursed for the 12 month period prior to becoming eligible for the release of OAR funds.
  - e. Non-IOI Payables - All non-Identity of Interest undisputed payables are less than 90 days old.
  - f. IOI Payables - No Identity of Interest vendors have been paid when there are non-Identity of Interest accounts payables over 90 days unless an “Accounts Payable Action Plan” is

approved by the Authority.

- g. Deferred Maintenance - All deferred maintenance items listed on the most recent inspection or re-inspection report have been responded to appropriately.
  - h. Fidelity Bond - The Employee Dishonesty/Crime Coverage Policy is current.
  - i. Annual Audit - The annual certified audit has been reviewed, approved, and indicates that no material weaknesses exist in the operation that could jeopardize the development.
  - j. Legal Liabilities - No pending or threatened claims against the mortgagor or disputed payables exist that would materially affect the financial condition of the development as reported in the most recent monthly operating statement.
  - k. Management Fee - For the last 12 months preceding the expiration date of the letter of credit, the development has paid a management fee equal to or less than the maximum basic management fee allowed by the Authority – **or** - liquidity (excluding owner contributions) is greater than or equal to the **approved** management fee less the management fee actually paid.
2. If the development has successfully achieved all the criteria, recommend an approval for OAR reduction/release. Otherwise, proceed to the next step.
  3. If possible, resolve all outstanding issues identified by the successful operation criteria by utilizing the OAR funds where necessary, for example providing funds to underfunded escrows and following up on any outstanding Asset Management requirements awaiting responses. If the outstanding issues can be resolved, recommend a potential reduction/release in the OAR balance, otherwise deny the reduction/release.
  4. Complete the Operating Assurance Review Recommendation (Mgmt 504B) form to process the request. Use the regulatory agreement to identify the proper reduction/release amount to the OAR balance. Any reduction/release shall:
    - a. First, take the form of a reduction to the letter of credit amount and second, result in a release of cash to the ORC account.
    - b. Releases in cash shall be transferred to the ORC account; after all regulatory requirements have been met. If the development has a TCAP loans, the released amount may be required to pay off the TCAP loan prior to the release transferring to ORC.

### **Replacement Reserves Administered by Another Agency**

If another agency, such as HUD or RD holds a developments replacement reserve, then the Asset Manager must request confirmation of the replacement reserve funding level from the

administering Agency. If the replacement reserve is underfunded, the OAR requests for reduction will be denied until the appropriate funding level is met at the administering Agency.

### **Monitoring and Processing OAR Letters of Credit (LOC)**

Any development with an OAR account partially funded with a letter of credit must be reviewed 30 days prior to the LOC's expiration date to process an update to the LOC's status. The status of the development also requires review when a disbursement or reduction is requested on the OAR account balance. Finance will notify the Asset Managers 30 – 45 days prior to the expiration of the letter of credit. The Asset Manager must provide a recommendation to Finance *at least two weeks prior to the expiration date*. When reviewing a Letter of Credit status, the Asset Manager may recommend the following actions:

**Extend** – This extends the expiration date of the LOC for another year. Verify the development is not eligible for a reduction in the OAR account balance based on the regulatory agreement and the development's operating success.

**Utilize** – The owner must be notified that MSHDA will cash in the LOC prior to this recommendation being processed. The LOC is cashed in to pay operating deficits, underfunded reserves, delinquent mortgage payments, or potentially to prevent expiration. In many instances the owner will want to bring in funding versus have the LOC cashed.

**Expire** – Only use this option if a reduction in the OAR balance has been approved for the amount of the LOC. Refer to "Development Operating Review and OAR Reduction/Release" section for more details.

**Reduction** - An LOC may also be allowed to be reduced if the owner brings in cash to contribute to the OAR account or to pay for an operating deficit. If this occurs, the reduction in the amount of the LOC will match the amount of funds paid in by the owner and does not require a successful completion of the Development Operating Review criteria.

Complete the Operating Assurance Reserve Recommendation form (Mgmt 504B) to notify Finance of an action on an LOC.

### **Loan Default or Recapture Obligation Event**

In the event that the Mortgage Loan, NSP Loan, HOME Loan, TCAP or other MSHDA held mortgage note is accelerated after a default by the Mortgagor, or the Mortgagor becomes liable for a Recapture Obligation, the Authority may, in its sole discretion, but is not required to, apply any funds on deposit in the OAR and OAE accounts to the amount due on the loan or to satisfy the Recapture Obligation unless otherwise stated in the Regulatory Agreement. A Letter of Credit may also be cashed to help satisfy an amount due on the loan or the Recapture Obligation unless otherwise stated in the Regulatory Agreement.



## **Discharge of the Mortgage Loan**

Upon payment in full and discharge of the Mortgage Loan and any other obligations to the Authority, any funds remaining in the OAR account (including the accrued interest) after payments to the Mortgagor of all allowable Limited Dividend payments, shall be the property of the Authority. The Mortgagor's rights to the OAR funds are limited to the rights stated in the Regulatory Agreement.

## **Attachments and Forms**

504A – Operating Assurance Reserve Development Review

504B – Operating Assurance Reserve Recommendation

504C – RR Fully Funded Letter

504D – RR Partially Funded Letter